

An uncertain future

As insurers look ahead to the 2008 renewal season, the prevailing sources of uncertainty are likely to continue: over the scope of the TRIA extension and over tense geo-political conditions that may contribute to the threat of a terrorist act. **Paul Knutson** and **Sean Mooney** report

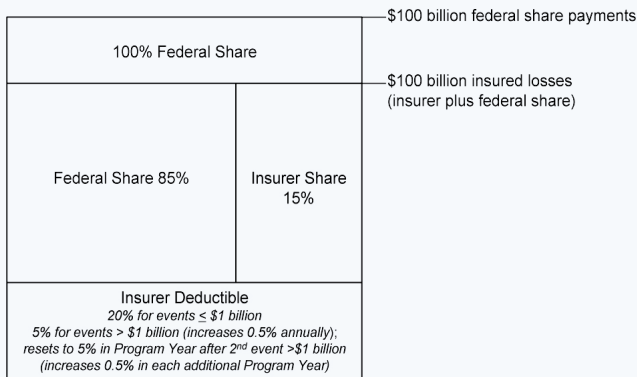
In an uncomfortable brush with déjà vu, at the time of writing federal involvement in terrorism insurance is again scheduled to expire by year's end unless an agreement is reached to extend the current programme. The Terrorism Risk

Insurance Extension Act of 2005 (TRIEA), itself enacted in the final hours of the legislative calendar year, is scheduled to expire on December 31, 2007. In contrast to the previous extension debate, stronger tailwinds exist today supporting

federal involvement in terrorism insurance. The ultimate scope of the new legislation remains in question, however, and therefore the scope of terrorism risk that insurers must manage on their own balance sheets is also in question. ▶

The US Coast Guard searches the port of LA for signs of terrorist activity

FIGURE 1: SCHEMATIC OF TRIREA COVER: CONVENTIONAL TERRORISM LOSSES



Source: Dewey and LeBoeuf, LLP

In the most recent congressional action on renewing federal terrorism legislation, on September 19, 2007, the US House of Representatives approved H.R. 2761, the Terrorism Risk Insurance Revision and Extension Act of 2007 (TRIREA).

If enacted, the law will succeed TRIA, which expires at the end of 2007.

Key features of the bill include:

- A 15-year extension. TRIA was first passed for three years (2002-2004) and then renewed for two more years (2006-2007)
- Mandatory offer of Nuclear, Chemical, Biological, Radiation (NCBR) cover. Insurer retentions for NCBR events start at 3.5%

Currently, policies that exclude NCBR do not cover if terrorism is the cause

- Coverage for acts of domestic terrorism. This is excluded under TRIA/TRIEA
- Insurer retentions for terrorism excluding NCBR at 20% of applicable direct earned premium. This is the same as 2007
- Trigger for events to be covered under the programme is reduced from \$100m to \$50m
- Group life insurance is included. It is presently excluded under TRIA/TRIEA.

POTENTIAL FLAW

The legislation passed in the House does contain a

potentially serious flaw in that a subsequent act of Congress is required to release federal TRIREA funds to provide compensation following a terrorism loss. The provision was added to move past current 'pay/go' requirements that prevent the authorisation of new federal funding without offsetting cuts. By requiring a second act of Congress, TRIREA theoretically has no cost. This provision will come under intense debate in the Senate as its inclusion threatens the viability of the programme as reinsurers, rating agencies and others have understandable doubts about a pledge of ensuing congressional action to release funds at what would surely be an intense, emotional and overtly politicised, post-loss environment.

Following the bill's passage in the House, given the more collegial interactions in the Senate, and, more basically, the effective need for 60 'yes' votes out of 100, compromise in the Senate is very likely.

Components of the measure that are prime candidates for modification include the duration of the term (15 years), NCBR compulsory offer and group life inclusion. The charts (above, and on page 47) illustrate the coverage provided under TRIREA.

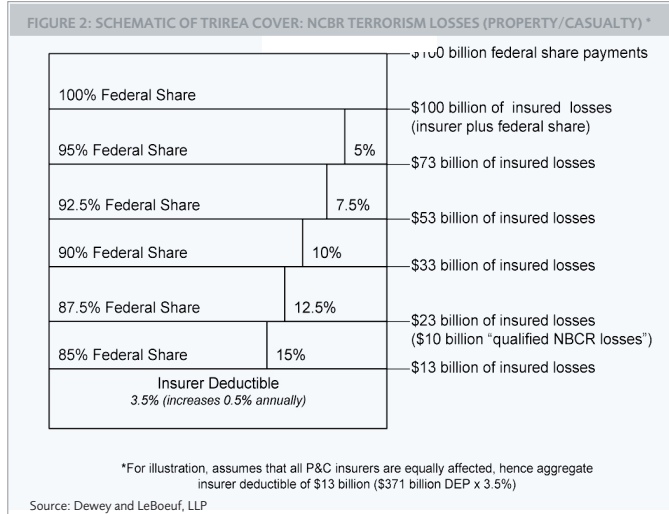
EXPANDING ON THE PROPOSED CHANGES

Most agree that some level of federal involvement in terrorism insurance is warranted, but views differ regarding the significant expansion of coverage contemplated by the legislation approved in the House of Representatives:

Domestic terrorism: Current TRIA language excludes acts of domestic terrorism. The lines of distinction between domestic and foreign terrorism are blurry, at best. This exclusion results in coverage gaps that must be filled by a company's own reinsurance programme or retained net. TRIREA would specifically cover all terrorism losses, irrespective of the known or perceived perpetrator. Cedants and their reinsurers will ultimately benefit from the clarity of eliminating the domestic/foreign distinction as coverage is contractually defined.

Covering more lines of insurance: All TRIA legislation to date covered only property and casualty insurance. Current TRIREA legislation includes group life insurance, capped at \$1bn for each person covered under a group life policy.

Lower coverage trigger: The TRIREA language reduces the trigger for a qualifying event



down to \$50m from the current \$100m. This is an important issue, especially for many smaller, regional insurers that may face localised, concentrated exposures, such as the workers compensation exposure at a conference or gathering. Reducing the qualifying trigger for federal coverage may also encourage the broader purchase of terrorism insurance coverage.

Inclusion of NCBR: This is a controversial change, should it remain in the final legislation. The current House bill requires insurers to offer NCBR coverage at similar terms and conditions as other terrorism insurance, and those policies are covered by TRIREA. Despite these exposures being covered by the TRIREA backstop, companies will have to manage their net

exposures to NCBR. Many reinsurers will expose a limited amount of capital to NCBR exposures on a case-by-case treaty basis, but the capital base of the reinsurance industry is inadequate to broadly assume NCBR exposures in peak cities or zones.

BUSH ON THE RECORD

Even at the point where consensus extension legislation emerges from Congress, the Bush Administration is on record stating that it plans to veto any legislation that significantly expands federal involvement in the programme. The President's Working Group on Capital Markets concluded in a September 2006 report that federal governmental involvement in terrorism

re/insurance is inhibiting the creation of more effective and efficient private market products that address terror risk. Much of the current public debate on the issue is clearly just political rhetoric, but the divergent views between the Administration and Congress do point to the likelihood of once again facing turbulent political waters, and resulting uncertainty, right up to the legislative deadline.

The issue of government preparedness in the face of disaster – whether natural or man-made – surfaced broadly following the terrorism attacks of September 11, 2001, and was further highlighted in the

impact and aftermath of Hurricane Katrina. Though many reinsurers would disagree, some TRIREA supporters see the extension legislation as a replicable model to be applied on a federal level to other types of catastrophic risk, including hurricanes, earthquakes and wildfire.

WHAT TO DO NOW

The tumultuous property reinsurance market of 2006 and early 2007 demanded many insurers' full attention as they balanced regulatory, budgetary and capacity availability issues in a hard market. With so much focus on property, innovation in terrorism reinsurance may

have appeared to temporarily stall, but the truth is that Guy Carpenter has recently worked with many cedants, and a willing reinsurance market, to create efficient, custom-tailored terrorism reinsurance solutions that support each cedant's unique strategy.

It is a fact that the reinsurance market has never been in a better capital position – from both an economic and a human capital perspective – to work constructively with insurers and brokers to manage terrorism risk. Guy Carpenter's recent, direct experience confirms that the reinsurance market is willing, even eager, to provide

Police investigate a backpack after the failed attack on the US Embassy in Vienna, Austria, October



terrorism reinsurance products that increasingly make clear sense to cedants when viewed from a cost/benefit perspective. Every terrorism reinsurance negotiation is unique, but some of the key features of various recent transactions include:

- Managing net terrorism retentions to company-defined target levels
- Allowing lines of business subject to terrorism risk to continue to grow
- Achieving lowest possible economic cost
- Accounting for unique transactions as reinsurance
- Including all lines of business
- Covering Nuclear, Chemical, Biological and Radiological (NCBR) exposures
- Protecting for fire following terrorism exposures
- Applying on an aggregate recovery basis
- Securing up to hundreds of millions of reinsurance limit per programme.

In a market driven by volatility the status quo can be fleeting. For now, insurers are in an ideal environment to step back and properly quantify terrorism exposures through sophisticated accumulation

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analysis and stochastic modelling techniques. Once that's done, companies need to assess their options for managing the terrorism risk and, if necessary, engage the reinsurance market in creating custom risk transfer solutions for complex terrorism exposures. The level of ongoing federal involvement in providing a terrorism backstop is uncertain, but it seems plausible that insurers will have more coverage in 2008 than they have today. ®

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